PUBLIC SERVICE COMMISSIONS

REMARKS UPON THE PAPERS OF SENATOR WILLIAM H. HATTON AND MR. THOMAS M. OSBORNE, AT THE JOINT MEETING OF THE AMERICAN ECONOMIC ASSOCIATION AND THE AMERICAN POLITICAL SCIENCE ASSOCIATION

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It is significant that one of the industries now under discussion was the subject of the first monograph published by the American Economic Association, and that the relation of the State to such industries was the topic that received most emphasis at the meeting called to effect the organization of that association.

Less than a decade before the organization of the association, the highest judicial tribunal of the land had recognized the public character of the industries in question, and the consequent right to regulate prices in the public interest. The idea that they are affected with a public interest has been slow to permeate the minds of the promoters and managers of the industries. As a means of enforcing this idea on the monopolists, the public, in violation of all sound theories, has often used so-called competition as a club to bring the companies to time. Long after the courts had declared these monopolies of a public character, and as such subject to public regulation, the public, ignorantly but honestly, attempted to maintain the public rights by limiting the length of franchises. This mistake has so far been a great impediment in the way of a satisfactory solution of our problem. The history of the undertakings under the limited franchise theory has been a close parallel to that in the previous period during the attempts at competing companies. All the world today recognizes the futility of competing companies. Advanced thinkers are not unanimous, but I will venture to predict are moving rapidly toward a unanimity of opinion that limited franchises, like competing companies, are to be justified, if at all, not as a means of regulation or as a method of obtaining directly, adequate service on equitable terms, but as a mere club or weapon with which to force some sense of restraint, justice and

fear into the minds of those recalcitrant managers of public service corporations, upon whose beclouded intellect it has not yet dawned that they are dealing with companies in which the public has very much more at stake than the legal owners have. What we want is not a franchise limited in time, but one so handled and controlled that the *future* unearned increment goes to the public, and, so drawn that the public can resume it at any time without formal forfeiting of it, the moment the company refuses to use it in a manner advantageous to the public. Such franchises are granted in the public, not the private interest; the owners tacitly, if not formally, agree to give service on terms advantageous to the public. So soon as a company ceases to be able or willing to render the public service on these terms, the most that it can properly ask is that it receive compensation or repayment for the money actually contributed by the shareholders and then get out. In order that the companies may receive the benefit of all doubts arising from the ambiguity of their legal rights, we are willing to give them in addition to what they have put in, the present value of their franchises, if on this basis they will fulfill their public duties. But to imply that a company should be given a *future* increment of value on a franchise, is to destroy at one blow the whole theory that the companies are public service companies, and thereby to wipe out all basis of controlling charges. For instance, to allow a street car company to charge a five cent fare today to pay a fair rate of interest on its investment and also on the value of its franchise, and to let it continue to charge five cents when the city and the traffic have increased tenfold on the ground that the franchise at the later date has increased in value till the earnings now are required to pay a fair rate of income on the value of the property and the franchise, is to reason in a circle. For the franchise was at the beginning already capitalized to the full limit that the market recognized any value in it. The value of the franchise of course depends on the rates permitted and actually collected. Social welfare demands in the future rates in all these services which will prevent any increase in the value of the franchise. The method of doing this is to put a value on the tangible property and also on the franchise worked out on some agreed scheme, such as that of Dr. H. C. Adams. Then see that rates in the future are kept down to a point that will give no surplus above a fair rate on this fixed franchise value plus a fair rate on the investment in tangible property.

All in excess of this belongs under the theory of regulation to the

users and should remain in their hand at all times through compulsory reduction of rates.

It is just ten years since I had the honor of reading a paper before one of these associations on the subject of the control of gas companies. In that paper I maintained that the attempts at regulation before the year 1897 had reduced the possible profits of the companies, but had not given adequate service at proper prices, while keeping the economic cost of rendering the service abnormally high. I further predicted, that

no regulating act beneficial to the public can be passed without the consent of the gas companies, nor can it be enforced without their coöperation.

This was meant as a gentle hint to the public to use various kinds of clubs to drive respect for human rights, and some recognition of their own social obligations into the minds of the promoters and managers of public service corporations. The world has moved at a swift pace, and over vast stretches of the then unexplored universe, within the intervening ten years. The more intelligent and notably the younger owners and managers have seen a great light. Such managers really want and are willing now to consent to many things to which they were violently opposed even ten years ago. They have recognized once for all that it is expedient to make formal acknowledgment at least of the public character of the industries. But while making such public profession, they have been fertile in inventing and causing to pass into law in many instances schemes of so-called regulation whose chief object was to prevent actual regulation, and to permit the companies to be run exactly as if the public had no interest in them.

The most powerful single influence tending to make the companies willing to submit to real regulation, has been the agitation for public ownership. The necessary and logical inference from the recognition of the monopolistic character and the public interest of the service, has been the alternative of regulating more effectively private ownership, or of passing to public ownership and management. It is not too much to say that among all the influences exerted against the companies, the agitation for public ownership has been far and away the most powerful. During all this beneficent agitation, the municipalizers have been blissfully ignorant of the fact that in the existing circumstances the evils against which they are striving are quite as sure to crop out in public as in private ownership, unless the public

ownership is subject to some administrative control by a force apart from the city government. The world has indeed moved since a distinguished president of the American Economic Association wrote (Hadley, *Railroad Transportation*, p. 54):

> A great many favor limitation of railroad construction. Whether this can ever be effectively carried out is more than questionable. * * * It is not easy to introduce a principle so foreign to the general tendency of our laws; and it may be questioned whether any advantages gained at one point would not be dearly purchased at another.

Let us hope that this will prove the last utterance by a man of scientific standing supporting the view that our public service industries are private affairs, from which the State should withhold its hand. Surely all agree today that there can be no control of public services until the public has the right to prevent unnecessary investment. Certainly, the scientific world in the intervening twenty years has decided that these industries should be monopolies. Upon this decision alone rests the right to regulate. There can be no such thing as a fair return upon investments in this field if the capital honestly invested may be raided by so-called competing companies, at will, thus duplicating the capital by unnecessary investment on which a fair return is then claimed in rate controversies.

It marked an epoch in dealing with public service companies, when the commission on public ownership of the National Civic Federation—a commission representing every phase of belief, affiliation and interest—declared in its final report with but one dissenting voice that the solution of the problem required that each community should have full right and power to take these industries into public ownership and management, at any time when the public interest could not be otherwise maintained. When the constitutional, statutory and financial authority for such action are fully established throughout the land, the opposition to effective control has no leg left on which to stand. The right to purchase by voluntary agreement and to operate, and the right to expropriate on the part of the public, is the the right to compel and to control without limit. The power to take life of a company, and also its property at a fair price, is the power to make the company the servant, not the master of the public. Anything short of this under present American conditions falls short of effectiveness. The new Wisconsin law rests on this principle, while the New York law is defective at this point.

May we not justly hope that after a generation of warfare in this matter, the year 1907, has ushered us into a new era of peace in these industries, in the sense that perpetual use of clubs, hammering and warfare, conditions the burdens of which always fall upon the public and which always raise the economic cost of service, may give way to an open, frank and sincere acknowledgment on the part of the owners and promoters of these services, that the services are public in their nature, and that, therefore, they must be adequately controlled by the public. If such prove not to be the case, and that right speedily, the undertakings not only will pass over into public ownership and management, but human progress requires that they should so pass. Let us hope that this changed attitude on the part of the companies may come and may so pacify the people that the public, whether represented at the polls, in the legislature and city council, the executive mansion, or embodied in controlling commissions, may lose some of its instinct for warfare, blood and destruction, and may be willing to coöperate with the private interests involved to give the owner of the private industry a guarantee of an opportunity to earn a fair return, in view of the risk, upon the money actually and necessarily invested in these enterprises.

The most significant attempts at regulation in the last generation have been embodied in the interstate commerce acts (acts which have not yet reached the legal age of 21 years) the railroad commission acts of Massachusetts dating from 1869, the Massachusetts gas and electric light commission acts dating from 1885, and the more recent commission acts relating to gas in New York and the amended railroad commission act of Wisconsin. To these ought to be added the national banking act (older than any of those previously named). Although this act does not relate to what under our law is a public service, the principle involved is so closely assimilated with the principle of the regulation of public utilities as to justify the mention of it in this connection. No one of these attempts at regulation, varied as they have been, has been without great value. Each of them, in its own way, has been of vital importance in educating, not only the consumer and the investor, but also the legislators and the managers of the private companies as well. If these various efforts be viewed, by and large, they will all be recognized as beneficial, and yet they have all fallen far short of the results which must be attained before regulation can be said to have accomplished its object in giving adequate and efficient service at proper rates. This is not to say that the

legislation in regard to these commissions, and the acts of the commissions themselves were not on the whole wise and pointed in the right direciton. It is simply a recognition of the fact that human progress is slow, and that a step of one kind may be absolutely necessary as a preliminary before a much wider step in the right direction becomes possible. As well criticise the steps of a two year old child, because they are not equal in length and steadiness to the steps of a vigorous adult man, as to condemn these commissions because they have not accomplished what it was impossible for them to accomplish under the then existing circumstances, although many of those things may prove to be possible of accomplishment under the legislation in regard to public utilities, enacted by the legislatures in Wisconsin and New York in 1907.

Let us summarize very briefly some of the essentials of regulation and then turn our attention to a summary comparison of the public utilities acts of 1907 for Wisconsin and New York, to see their relative significance when measured alongside of these fundamentals. Before making the comparison, it ought to be remarked parenthetically that the principles of control of a privately owned monoply by a power entirely distinct, not only from the owners and managers, but also from the consumers of the company, apply with equal force to the regulation of a publicly owned monopoly.

First, then, if regulation is to be successful, there must be a uniform system of accounts, records and reports for like service in each of the States. This point involves also actual and frequent public auditing, and a real publicity not only of the auditing, but of the accounts. This implies the acknowledgment to a greater extent than has yet been attained on the part of the owners, that these industries are of so public a nature that the public has the right to know every detail of the organization, financing and management of the undertakings, to as full an extent as it has the right to know in regard to the management of the public schools or the health department of a city. There is, and there can be no effective regulation until the companies are compelled or induced to act in good faith on this principle, and until the controlling organs of the State have money enough and experts enough to put this principle into effective operation. Nor can the idea be made effective in practice until the organ of the State which has supervision of these industries has financial resources enough, and employs a sufficient number of professional accountants and auditors to keep the facts of these industries in an intelligent form before the

city council, the legislature and the consuming public. The accounts and the results of the auditing must not only be public, but they must be published, and actually brought before the voting portion of the public in such a manner as to enable the laymen to understand and compare them for the same company year by year, and also with other companies. Of course, with this degree of publicity the companies must in justice be protected and be permitted to protect themselves from a competition by trade and traffic agreements (subject of course, to approval by public authority and also made public). The rule must work both ways. This brings us to the same point again, namely, the recognition of the public character of the services.

The Massachusetts commissions already referred to, and the interstate commerce commission have had nominal power to do a large part of the work of control within this field, but unfortunately, at no time have they had the funds, or any expectation of obtaining the funds within a reasonable number of years, to employ a sufficiently large and sufficiently permanent staff, to do this work satisfactorily. What is true of the auditing, accounting and reporting is equally true of the engineering. Real control can never be obtained until the commission has constitutional, statutory, and financial power to organize, maintain and direct a more adequate and effective engineering force in the field of each industry under the control of the commission, than is maintained by the largest and strongest company. When the whole world knows and understands the conditions of the industries through the work of the accountants and the engineers, we have made some real approach toward the regulation of prices, and we have come nearer to the solution of that vexed problem, the taxation of public service corporations. Here it is that we come to the first great technical difference between the public service commissions of New York and of Wisconsin.

Under the legislation of 1907, each of these commissions is nominally given unlimited power of inspection, investigation and of fixing the price of services, within the constitutional requirements regarding due process of law, and just compensation to be determined by judicial authority. Almost every provision that ingenuity can invent seems to have been inserted in both acts to prevent the courts from interfering unduly with the work or orders of the commissioners, and to prevent the companies from using the courts to stay orders of the commission pending a decision on their legality. The relation of the

New York commission to the courts seems to be somewhat more promising than that of Wisconsin.

In the matter of rate regulation we have come face to face with the fact of capitalization, stock watering and franchise values. As I have so often said in the last twenty years, proper consideration of the equities in the case of innocent holders and a due respect for the untold legions of widows and orphans involved in the controversy, as well as every consideration of mere expedience requires that the stock watering of the past, so far as it is reflected in the market values of securities and in the present earnings of companies, and so far as it has been recognized as legal up to the present time, should be accepted on the ground that both the public and the companies have responsibilities for existing conditions. But as previously stated, all *future* increment in the value of the franchise should be prevented by rate reductions or improvement in the service. The Wisconsin law has recognized a principle which heretofore has been but little regarded, although it is emphasized in the new Virginia constitution and the legislation resting upon it, namely, that whatever the specific legal terms or length of existing franchises may be, they have but little actual value in a growing community. A perpetual franchise to operate a street car line over a few miles of line only, in a growing city, has no practical value for the reason that additional franchises become absolutely essential at very frequent intervals to the life of the company. The State, therefore, finds itself almost everywhere with an actual right of amending franchises where no legal right exists, for to refuse a great company the necessary powers to enable it to meet the expanding needs of the community, is virtually to abolish the existing franchise, for this right to refuse amendments can be used by the legislature to obtain from the company a waiver of any rights considered injurious to the public. This enables the State to bring every corporation in all details under the provisions of an act establishing control according to the prevailing idea of justice at the present time.

The Wisconsin law has provided for this, but the control of rates rests on the idea that the owners of the enterprises are entitled to charge rates which will give them a fair return upon the capital actually and necessarily invested to render the service. This implies of course that the capital is not only honestly invested and managed, but is managed with a reasonable degree of skill and efficiency.

The sequel will probably prove that the most important step yet

taken in America in the field of regulating public service corporations is to be found in the provisions of the Wisconsin law compelling the uniform accounting, auditing, and publicity, together with the requirement of the valuation of the physical assets. This provision for valuing the property is not, as the companies seemed to believe before the act was passed, an attempt to squeeze the existing water out of capitalization, or to destroy the value of the existing franchises. It is a mere step, and a necessary one, to determine the value of the existing property and franchises and to obtain the other necessary information without which the right to regulate prices has no basis in equity, but degenerates into the old idea of a club or weapon with which to punish the companies. This provision may properly be regarded as an attempt to seize the *future* (*not the existing*) unearned increment on the franchise for the public. It leaves the existing value of the concern, including the capitalized value of the franchise, in the hands of the present holders. Any proposition short of this really destroys the foundation for regulating prices, and throws us back on the old idea that the companies are really private companies. In fact, to shut off the valuation of the physical assets is to hurl us back into the era of so-called competition, with all of its corruption. But these companies are really public. They are logically monopolies. From these two facts it follows that they ought to have their prices regulated. There can be no just ground in an age of reason and intelligence for permitting private owners to own, capitalize and exploit forever the constantly growing value of these public franchises. It is the height of folly to advocate any rate regulation without a valuation of the physical property. No order affecting charges can be issued in any particular case except on the basis of the value of all property, tangible and intangible. How much better to fix this valuation deliberately and calmly, for all companies, when there is no strife on, rather than in the heat and haste of a bitter controversy in a particular case. It may be in some cases that the franchise furnishes the chief item of property, but the chief claim to compensation by the private owners must rest in the future on their contributions of capital. Until the amount of that is determined, of course, it is utterly impossible to determine the value of the franchise. For the combined value of the two is determined largely by the earnings. This total value cannot be analyzed or separated into its component parts without a valuation of the physical property. The forces acting upon the value of a franchise are dif-

ferent in origin, direction and effect from those acting on the value of the physical property. The one kind of value decreases by time and decay, the other increases with every step in human progress. The only justification for allowing any financial return to the franchise of a public service company rests on the historical fact, that such companies, before the public knew that they were of a public nature, were allowed to charge prices for the service, which paid what was considered a fair return on the capital actually invested and in addition furnished the basis for a high value of the franchise. Then the companies were permitted to issue capitalization against this value, and even to make false declaration as to the amount of such earnings, and thereby base excessive amounts of their watered capitalization on this surplus, and then palm such securities off on the innocent investor, the widow and the orphan, for whom protection is now claimed. Every element of value, tangible and intangible, ought to be taken into consideration in fixing the present value, both for taxation and the fixing of rates; but as already indicated, the basis and starting point of all valuation for these purposes is the valuation of the physical property, without that no scientific progress can be made.

In the two fundamental requisites of effective regulation, uniform accounting, together with public auditing, and the valuation of the tangible property, the Wisconsin law seems immensely superior to that of New York. I should say that the most hopeful feature of the New York law has nothing to do with the formal powers conferred upon the commission, but relates rather to the fact that as nearly as may be under a constitutional government, the commission has placed at its service unlimited funds with formal authority of so broad and autonomous a nature conferred upon the commission, that it may if it pleases, establish uniform accounting, auditing and reporting; organize and maintain whatever staff of engineers, accountants, librarians, statisticians and other experts seems necessary, and may if it chooses, beyond doubt, establish a physical valuation of the plants. Until the law is changed, that commission seems much less likely to be hampered from lack of funds, than the Wisconsin commission. The practical danger in New York is that the commission will be swamped with what seem pressing demands upon its time and energies, and will involve itself in an untenable position in an attempt to prevent stock watering by passing upon petitions for the issue of stocks and bonds. Petitions of this sort may easily be made to

occupy the major portion of the time of the commission to the exclusion of more important matters. The practical way to prevent stock watering, is to value the physical property of the company and fix the value of the franchise at the same time. This will check stock watering by making it utterly useless.

All previous attempts at regulation, state and federal, have been shipwrecked after accomplishing relatively little, by the inadequacy of the appropriation placed at the disposal of the controlling organ. Let us hope that the reorganized interstate commerce commission of 1906, and the recently established public utilities commissions of New York and Wisconsin will be able, even under the pressure of an impetuous and somewhat uneducated public opinion, to accomplish such a degree of success as will, once and for all, convince the public that all human government, in as complex affairs as these commissions are required to deal with, is a scientific matter, requiring expert knowledge, both of a higher degree and also of a much larger mass than has heretofore been recognized, and that these can be obtained only by large expenditures of money, and, expenditures too, on a very much larger scale than the public has heretofore deemed necessary.

In this respect the New York commissions (and notably that of the first district) are much more interesting experiments than that in Wisconsin. The problems in the first district of New York are unfortunately, more dynamic at present and more consciously pressing for solution. Fortunately, the people begin to realize that vast sums of money are required for their solution. It is an inspiring sight therefore, to see the resources of that district placed so much more largely than in any instance heretofore in America at the disposition of the public service commission. Every well wisher of America, and every man who has come to realize that unregulated private monopoly in important public service is oppressive and unendurable ought to rejoice at the experiments now going on both in Wisconsin and New York, and to recognize them as probably the most important experiments in human government yet undertaken in America. Not least of all should he rejoice in the high character of the commissioners, and in the fact that, coupled with large legal powers, these commissions, especially in New York (first district), have adequate funds placed at their service to enable them to carry on their work. Let us all pray that public sentiment may so far be held in check as to give these commissions substantially on the present basis, a considerable number of years to wrestle with this problem before their powers are

greatly curtailed, or possibly destroyed by further and hostile legislation. Either law is good enough to bring about marvelous progress if only it can be saved from change, or the serious fear of change, until it has a chance to show what can be done under it.